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FEDERAL COMMUNICATIONS COMMISSION
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**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| In the Matter of | ) | |
| | ) | |
| Implementation of the Telecommunications Act of 1996: | ) | CC Docket No. 96-150 |
| | ) | |
| Accounting Safeguards Under the Telecommunications Act of 1996 | ) | DOCKET FILE COPY ORIGINAL |

**COMMENTS OF THE**
**COMPETITIVE TELECOMMUNICATIONS ASSOCIATION**

Genevieve Morelli
Vice President
and General Counsel
**Competitive Telecommunications Association**
1140 Connecticut Ave., N.W.
Suite 220
Washington, D.C. 20036
(202) 296-6650

Danny E. Adams
Steven A. Augustino
Andrea D. Pruitt
**Kelley Drye & Warren LLP**
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

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## EXECUTIVE SUMMARY

For many years, the Bell Operating Companies ("BOCs"), have maintained an unchallenged stronghold in the provisioning of basic local services. With the passage of the Telecommunications Act of 1996 (the"Act"), many more companies have the opportunity to enter the local exchange market thereby providing consumers with greater choice in service providers and service offerings. Likewise, the BOCs might achieve additional opportunities to expand their frontier to provide services from which they were barred by the line of business restrictions of the MFJ, including interexchange services and manufacturing. While the changes brought about by the Act have the potential to propel the United States' telecommunications industry to unparalleled heights of competition, poor implementation of the Act could cripple the development of competition thereby harming rather than promoting the public interest. Accordingly, CompTel urges the Commission to continue to develop policies that will inhibit BOCs and other local exchange companies from manipulating their newfound liberties to achieve anticompetitive results.

Critical to the protecting competition in all telecommunications market is the implementation of accounting safeguards adequate to respond to the new challenges created by a transition to a fully competitive and vertically-integrated telecommunications marketplace. With this goal in mind, CompTel agrees with the Commission that its existing rules should serve as a baseline for the new competitive structure, but that these rules must be strengthened to counter increased opportunities for cross-subsidy and anticompetitive pricing. Accordingly, as a general matter, CompTel urges the Commission to apply, at a minimum, its cost allocation rules to prevent such anticompetitive behavior.

As discussed in the comments herein, the Commission must be careful to implement rules which can effectively counter attempts by BOCs and other local exchange carriers to subsidize their competitive services with revenues generated from the local exchange market. Thus, first and foremost, as it did in Docket 96-149, CompTel urges the Commission to strictly enforce the requirement that the BOCs provide manufacturing and most interLATA services through affiliates that are independent to the greatest extent possible.

To create sufficient accounting safeguards for integrated operations, the Commission must be careful not to misconstrue the scope of services the BOCs may offer on an integrated basis, whether it is the "incidental" services exception or the exception for out-of-region services. The Commission must also apply dominant carrier regulation both to out-of-region services offered on an integrated basis and to incidental services, if offered on an integrated basis. Additionally, where a BOC offers interLATA services on an integrated basis, the Commission should require that all costs related to interLATA activities be treated as nonregulated costs under the *Joint Costs* rules.

With regard to the provision of payphone services by independent local exchange carriers ("ILECs"), CompTel agrees with the Commission that Section 276(a)(1)'s prohibition against subsidization its payphone service "directly or indirectly" from local exchange or exchange access revenues is integral to the deployment of payphone service. CompTel also agrees that the BOCs, on a going forward basis, must reclassify all payphone costs as a nonregulated activity under the Commission's cost allocation rules, and the Commission, must apply the *Computer III* non-structural safeguards as a minimum standard for payphone activities.

Consistent with its comments in Docket No 96-149, CompTel submits that structural separation is important for the competition in the telecommunications industry but, by itself does not eliminate the need for accounting safeguards. Accordingly, CompTel supports the Commission's tentative conclusion to apply its existing affiliate transaction rules to any services provided through separate affiliates. To further ward against improper affiliate transactions, CompTel urges the Commission to apply dominant carrier regulation to BOC affiliate services as well as implement safeguards discussed fully in Docket 96-149. Specifically, CompTel encourages the Commission to implement the following: (1) adopt safeguards similar to those proposed by the Department of Justice in the Ameritech Customers First Plan; (2) prohibit the BOC from joint marketing, sharing administrative functions and from guaranteeing its affiliate's debt in any way; and (3) require public disclosure of all transactions between the BOC and its affiliate as if the affiliate were a publicly-traded company.

Finally, if the Commission applies rules which meet the minimum standards set forth above, CompTel then agrees that the Commission should treat the interLATA affiliates as nonregulated under the Commission's joint cost and affiliate transaction rules for exchange carrier accounting purposes. CompTel encourages the Commission to strengthen its existing rules in the following ways: (1) apply a uniform valuation method to all affiliate transactions, require the BOC affiliate to take all services pursuant to the BOCs' generally applicable tariff and prohibit the BOCs from using "prevailing company prices' to value transaction between itself and its affiliates; (2) require two full audits encompassing all details regarding the audited parties' compliance with affiliate transaction rules and any other nondiscrimination requirements while the intraLATA affiliate mandated; (3) prohibit against joint marketing efforts between the BOC and its affiliates; and (4) initially classify the BOC affiliates as dominant providers and reconsider the classification only after it has had sufficient experience with BOC provision of in-region interLATA services to be confident that the BOC cannot exert market power in this market.

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**COMMENTS OF THE COMPETITIVE TELECOMMUNICATIONS ASSOCIATION**

The Competitive Telecommunications Association ("CompTel"), by its attorneys, respectfully submits the following comments on the Commission's *Notice of Proposed Rulemaking* in the above-captioned proceeding.[1] For the reasons explained below, CompTel supports the Commission's effort to revise its accounting safeguards to respond to the new challenges created by the transition to a fully competitive and vertically-integrated telecommunications marketplace. CompTel agrees with the Commission that its existing rules should serve as a baseline for this new competitive structure, but that the safeguards need to be strengthened to take into account increased opportunities for cross-subsidy and anticompetitive pricing.

[1] FCC 96-309 (rel. July 18, 1996) ("*NPRM*").

# I. INTRODUCTION

CompTel is a national industry association comprised of competitive telecommunications providers that vary in size from several billion dollars in annual revenue to only a few million dollars. CompTel's members provide a full range of telecommunications services today, and, like all industry participants, they now must reassess every aspect of their businesses as a result of passage of the Telecommunications Act of 1996 ("Act").[2] CompTel was intimately involved in the legislative process that led up to this historic legislation, and has been an active participant in the Commission's many proceedings to implement the Act. CompTel's members have an obvious and critical interest in ensuring that the Act achieves its goal of full and fair competition in every telecommunications market.

This proceeding and its companion docket, CC Docket No. 96-149,[3] address the significant challenges brought on by greater participation by traditional local exchange carriers ("ILECs") in markets other than local exchange services. While in the past the largest traditional local exchange carriers -- the Bell Operating Companies ("BOCs") -- enjoyed a monopoly in local services and were barred from participating in many telecommunications markets, the Act aims to change both of these facts. Sections 251 and 252 of the Act are intended to break the BOCs' stranglehold on local services and allow new

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[2] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996).

[3] *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as Amended and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, Notice of Proposed Rulemaking, CC Docket No. 96-149, FCC 96-308 (rel. July 18, 1996).

entrants to challenge the BOCs for local exchange customers. Ultimately, if the BOCs fulfill their obligations under the Act, they will be permitted to enter the manufacturing and interexchange services markets from which they were barred by the line of business restrictions of the *Modified Final Judgment* ("MFJ").[4] In addition, simultaneous with the opening of the local exchange, the Act permits the BOCs and other LECs to enter other markets such as telemessaging, electronic publishing, and payphone services, upon various conditions and subject to the Commission's oversight.[5]

These fundamental changes present significant regulatory challenges. As attested by the mammoth size and extensive detail of the Commission's 700 page *Interconnection Order*,[6] ending the ILECs' monopoly on local services will require the active leadership of both state and federal regulators to bring Congress' goal to reality. Moreover, as the BOCs and other LECs increase their participation in markets which rely upon local exchange and exchange access services, the opportunities for misuse of common costs and facilities increase dramatically. The Commission's task in this proceeding is to develop policies that will limit the possibility that the BOCs and other LECs will manipulate costs for anticompetitive purposes. If the Commission is successful, the public will enjoy the benefits of additional stimuli to all telecommunications markets. If the Commission handles this task

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[4] *United States v. AT&T*, 552 F. Supp. 131 (1982), *aff'd sub nom Maryland v. United States*, 460 U.S. 1001 (1983).

[5] *See, e.g.*, 47 U.S.C. §§ 274-76.

[6] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, FCC 96-325 (rel. August 8, 1996).

poorly, however, competition will be undermined and the public interest will be harmed rather than helped.

Overall, CompTel supports the balanced, cautious approach advocated in the *NPRM*. CompTel believes that the Commission's existing rules are an adequate starting point for addressing these new challenges, but that they need to be strengthened in several critical areas in light of the historic changes that will occur as a result of the Act. CompTel urges the Commission to strictly enforce the requirement that the BOCs provide manufacturing and most interLATA services through affiliates that are independent to the greatest extent possible. If structural separation is meaningful, then the Commission may rely upon its current cost allocation rules for other activities permitted to be conducted on an integrated basis and upon strengthened affiliate transaction rules for activities conducted through a separate affiliate.

## II. THE COMMISSION SHOULD BUILD UPON ITS EXISTING ACCOUNTING SAFEGUARDS RATHER THAN REPLACE THEM

The *NPRM* concludes that the Commission's existing accounting safeguards should be retained, but with some additional strengthening.[7] CompTel agrees that this is the correct approach. The Commission's existing rules are the bare minimum of what is necessary to adequately address the potential for anticompetitive activity by the BOCs and other ILECs. They should form the baseline for the Commission's new rules, to be supplemented by additional safeguards tailored to the new telecommunications environment.

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[7] *NPRM* at ¶ 11.

In the *Joint Cost* and *Computer III* proceedings, the Commission adopted a series of accounting and other non-structural safeguards intended to ensure that the BOCs do not misallocate costs and engage in anticompetitive pricing practices.[8] These requirements were adopted in an environment where the BOCs clearly possessed *de jure* and/or *de facto* monopolies within their local service regions. Even though, by and large, the BOCs' non-local exchange activities were limited and peripheral to local services, the restrictions were deemed necessary to limit the BOCs' ability to exercise their local market power to their advantage in related telecommunications markets.

As a result of the 1996 Act, the BOCs may ultimately lose that market power, but that is not now the case. Despite the efforts by many pioneering CLECs and the progressive policies of a handful of states prior to the 1996 Act, the BOCs and ILECs still possess market shares in exchange and exchange access services (measured in revenues) of over 99%

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[8] *See Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 2 FCC Rcd 1298 (1987) ("*Joint Cost Order*"); *Amendment of Section 64.702 of the Commission's Rules and Regulations,* 104 FCC 2d 958 (1986) ("Phase I Order"). *recon,* 2 FCC Rcd 3035 (1987) ("Phase I Recon. order'), *further recon,* 3 FCC Rcd 1135 (1988) ("Phase I Further Recon. order"), *second further recon.*, 4 FCC Rcd 5927 (1989) ("Phase I Second Further Recon."), Phase I Order and Phase I Recon. Order vacated, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (California I"); Phase II, 2 FCC Rcd 3072 (1987) ("Phase II Order"), *recon.* 3 FCC Rcd 1150 (1988) ("Phase II Recon. Order"), *further recon,* 4 FCC Rcd 5927 (1989) ("Phase II Further recon. Order"), Phase II Order, vacated, *California I.* 905 F.2d 1217 (9th Cir. 1990); *Computer III Remand Proceedings*, 5 FCC Rcd 7719 (1990) ("ONA Remand Order"), *recon.*, 7 FCC Rcd 909 (1992), pets. for review denied, *California v. FCC*, 4 F.3d 1505 (9th Cir. 1993) ("California II"); *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, 6 FCC Rcd 7571 (Computer III Remand"); BOC Safeguards Order, vacated in part and remanded, *California v. FCC*, 39 F.3d 919 (9th Cir.) ("California III"), cert. denied, 115 S. Ct. 1427 (1995).

within each of their operating territories.[9] Moreover, the pro-competitive reforms mandated by the Act, while intended to create conditions where others will be able to erode that market power, will require significant changes in BOC and other ILEC practices and likely will take years, if ever, for a fully competitive environment to develop. Thus, for the foreseeable future the BOCs and other ILECs will continue to possess the same market power in local services that they did when the Commission's existing rules were adopted.

In addition, the BOCs and other ILECs now possess a greater opportunity to exploit that market power in related telecommunications markets. The Act permits, upon specified conditions, greater BOC and ILEC participation in other telecommunications (and non-telecommunications) markets. Moreover, the services which the BOCs ultimately may be permitted to provide are much more closely related to local services than ever before. Therefore, the danger of anticompetitive conduct is increased, at least in the near term while the market power of the BOCs and other ILECs remains unchecked. In other words, the expansion of BOC and ILEC participation increases the incentive for anticompetitive activity immediately, while actions to reduce their ability to act upon those incentives will take much longer to be effective. Therefore, in the near term at least, careful regulatory scrutiny is critical to ensuring that the BOCs and ILECs do not act upon their incentives to frustrate competition.

Some commenters in this docket are certain to argue that the move by many federal and state regulators away from traditional rate of return regulation has made the threat of cross subsidy obsolete, but that is not the case. First, price cap regulation that contains any

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[9] *NPRM* at ¶ 6 (citing TRS fund worksheet data).

form of sharing continue to create incentives for LECs to shift costs to their regulated accounts, in order to avoid or minimize the sharing mechanism. Second, even under pure price cap regulation, cost shifting can allow the LEC to maintain artificially high prices for essential services needed by competitors at the same time that it undercuts competitors' prices in the more competitive market. This strategy can be effective because the LEC retains market power in local exchange services, and thus has the ability to control prices for those services. Third, under the pricing methodologies adopted in the *Interconnection Order*, an ILEC has an incentive to shift costs to the provision of local exchange elements, in order to maximize the TELRIC-based price that it may charge. This can be done, for example, by increasing the joint and common costs associated with an element (which a state may allocate in any reasonable manner). Thus, the danger of cost manipulation by ILECs remains even under price cap regulation.

Since the BOCs continue to possess market power and the Act creates greater opportunities for the exercise of that power in the near term, the Commission's rules must be sufficient to meet the threat to the public interest. At a minimum, it will require the application of current cost allocation rules. Although those rules are a minimum requirement, as explained below, they are insufficient in several critical respects and must be strengthened over what applies today. Accordingly, the Commission should build upon today's existing regulatory scheme with rules that are as strong as or stronger than those in existence today.

## III. SAFEGUARDS FOR INTEGRATED OPERATIONS

The first part of the *NPRM* addresses accounting safeguards to be applied to non-local exchange services provided directly through a BOC's local exchange entities. Where such integrated activities are permitted, the Act prohibits the BOC from subsidizing its competitive services with revenues generated from the local exchange.[10] CompTel agrees with the Commission that its existing cost allocation rules may be used, with modifications, to protect against improper cross-subsidies.

### A. BOC Provision of InterLATA Services

The Act allows the BOCs to offer out-of-region and "incidental" services on an integrated basis, but requires that all other interLATA services be offered through a structurally separate affiliate.[11] The Commission must be careful not to eviscerate this balance struck by Congress by misconstruing the scope of services the BOCs may offer on an integrated basis, whether it is the "incidental" services exception or the exception for out-of-region services.

First, as CompTel advocated in Docket 96-149, the Commission should define incidental services to include, as the name "incidental" suggests, only services for which the fact that a transmission crosses a LATA boundary is inconsequential or insignificant.[12] By clarifying the definition in this way, the Commission preserves Congress' intent to protect

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[10] *See, e.g.*, 47 U.S.C. §§ 254(k); 271(h); 276(a)(1).

[11] 47 U.S.C. § 272(a)(1).

[12] CompTel Docket 96-149 Comments at 9-10.

competition in interLATA services and restricts the accounting problems created by BOC integrated operations to a more manageable scope. Second, as to out-of-region services, the Commission should strictly enforce this distinction to ensure that only services originating outside the BOCs' local exchange regions are eligible for integrated operations. In particular, the Commission should be mindful of the potential that a BOC will use mergers or joint ventures in an attempt to circumvent the requirements for providing in-region services. CompTel urges the Commission to treat as "in-region" all areas where a BOC and its merger or joint venture partner operate, and to apply its rules upon the announcement of the proposed merger or joint venture.[13]

The Commission already has taken a step towards managing cost allocation issues raised by BOC integrated operations by applying, albeit on an interim basis for now, dominant carrier regulation to out-of-region interLATA services offered on an integrated basis.[14] Permanent rules regarding BOC out-of-region services are pending, and CompTel urges the Commission to reaffirm here its decision to apply non-dominant carrier regulation only when a BOC uses a separate affiliate. However, as CompTel advocated in Docket 96-61, the Commission should strengthen the conditions necessary to consider an affiliate "separate."[15] Finally, CompTel recommends that dominant carrier regulation apply both to out-of-region services offered on an integrated basis and to incidental interLATA services, if offered on an integrated basis.

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[13] *See* CompTel Docket 96-149 Comments at 11-13.

[14] *Bell Operating Company Provision of Out-Of-Region Interstate, Interexchange Services*, Report and Order, ¶¶ 33-34, CC Docket 96-21, FCC 96-288 (rel. July 1, 1996).

[15] CompTel Docket 96-61 Comments at 4.

In addition, when a BOC offers interLATA services on an integrated basis, the Commission should require that all costs related to interLATA activities be treated as nonregulated costs under the *Joint Cost* rules.[16] As the Commission notes, this is the approach it has taken, on an interim basis, for BOC out-of-region interLATA services.[17] If applied to other interLATA services as well, this approach will reduce the opportunities for BOCs to misallocate costs between its local exchange and interLATA operations because this cost allocation approach assigns common costs to the interLATA operation whenever there is any doubt regarding its proper attribution to a service. Thus, it is more conservative than other approaches, and will allow the already competitive interLATA services market to discipline the BOCs' interLATA operations to the greatest extent possible.

### B. ILEC Provision of Payphone Services

Section 276(a)(1) of the Act prohibits a BOC from subsidizing its payphone service "directly or indirectly" from its local exchange or exchange access revenues.[18] CompTel agrees that this prohibition is an "integral part" of the Act's goal to promote the widespread deployment of payphone services.[19] It therefore urges the Commission to interpret this provision broadly to include not only the costs of installing and maintaining payphones, but also -- to the extent BOCs are permitted to participate in the selection of presubscribed

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[16] *NPRM* at ¶ 39.

[17] *Id.*

[18] 47 U.S.C. § 276(a)(1).

[19] *NPRM* at ¶ 57.

carriers -- the cost to the BOC (or its affiliate) of providing 0+ service or 0+ commissions to site owners. A BOC should not be permitted to subsidize these expenditures with revenues from its local exchange or exchange access operations.

In addition, CompTel agrees that, on a going forward basis, the BOCs must reclassify all payphone costs as a nonregulated activity under the Commission's cost allocation rules.[20] Moreover, while CompTel agrees that the *Computer III* non-structural safeguards must, at a minimum, be applied,[21] the Commission should also apply any additional rules it develops for other nonregulated activities to a BOC's payphone activities.

### C. Scope of the Commission's Authority Over InterLATA and Payphone Services

CompTel believes that the FCC has authority over both the interstate and intrastate aspects of integrated interLATA services and payphone services.

With respect to interLATA services, CompTel supports the Commission's tentative conclusion that Sections 271 and 272 confer authority over interstate as well as intrastate interLATA services.[22] As CompTel explained in Docket 96-149, this conclusion is supported not only by the language of Sections 271 and 272, but also by their relationship to the statute as a whole. Sections 271 and 272 are inextricably linked with Sections 251 and 252, which require the BOCs to open their networks to competitors. Recently, the Commission concluded that Sections 251 and 252 apply to *both* interstate and intrastate

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[20] *Id.* at ¶ 59.

[21] *Id.* at ¶ 58; *see* 47 U.S.C. § 276(b)(1)(C).

[22] *NPRM* at ¶ 43.

aspects of interconnection.[23] As the Commission explained, the Act creates a new regulatory framework which is "designed to open telecommunications markets to all potential service providers, without distinction between interstate and intrastate services."[24] Given that full compliance with Section 251 is an essential predicate to BOC interLATA entry under Section 271, the same conclusion is appropriate for Section 271. Second, the operative language of Sections 271 and 272 applies without distinction between interstate services. Specifically, Sections 271 and 272 apply to any services that are "interLATA." The Act defines "interLATA services" as "telecommunications between a point located in a local access and transport area and a point located outside such area."[25] Thus, a communication is within the scope of Sections 271 and 272 whenever it terminates outside the originating LATA, without regard to whether the communication crosses state boundaries.[26]

Even if the Commission concludes that these Sections, unlike Sections 251 and 252, do not apply to intrastate services, it also is clear that the Commission may legally preempt

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[23] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, FCC 96-325, ¶¶ 83-84 (rel. Aug. 8, 1996) ("*Interconnection Order*").

[24] *Id.* at ¶ 83.

[25] 47 U.S.C. § 153(21).

[26] Furthermore, because the Act substitutes Section 271 for the interLATA line of business restriction in the MFJ, it is reasonable to assume that Congress intended Section 271 to apply to the same scope of services (albeit applying different substantive rules to them) as covered by the MFJ. As the Commission noted, "[it is] implausible that Congress could have intended to lift the MFJ's ban on BOC provision of interLATA services without making any provision for orderly entry into intrastate interLATA services, which constitute approximately 30 percent of interLATA traffic." *NPRM* at ¶ 48.

state regulations that interfere with the Commission's authority to regulate interstate interLATA services.[27] CompTel believes that accounting safeguards for BOC interLATA operations is one such area where state regulation could interfere with federal policy. If a state's regulations provided insufficient protection, for example, a BOC could subvert Congress' prohibition on cross-subsidization by shifting costs to the intrastate jurisdiction, where it could cross-subsidize with impunity. The most effective way to prevent this is to preempt state cost allocation rules which are inconsistent with the Commission's rules.

## IV. SAFEGUARDS FOR STRUCTURALLY SEPARATE OPERATIONS

The second portion of the *NPRM* addresses accounting rules which apply when a BOC or LEC provides services pursuant to a structurally separate affiliate. To be sure, structural separation is an important safeguard, which CompTel strongly supports.[28] However, structural separation, by itself, does not eliminate the need for accounting safeguards, because it does not affect the BOCs' incentive to favor its affiliate. A primary purpose of the structural separation requirement is to force the LEC and its affiliate to operate independently, so as to make discrimination in the quality of access and/or the quality of service rendered easier to detect and to reduce joint and common costs among the operations. While structural separation reduces common costs, thereby reducing the danger of misallocation of shared costs, it creates a new danger of improper dealings between the

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[27] *See California v. FCC*, 39 F.3d 919, 932-33 (9th Cir. 1995).

[28] CompTel Docket 96-149 Comments at 13-20.

affiliates. For example, the parent company may find that it maximizes the profits of the combined enterprises if it reduces the profits of one of the BOC operations in order to secure greater profits for its affiliate. This scheme can easily be accomplished by the parent company engaging in favored transactions between its local exchange company and its other affiliated companies.

Therefore, CompTel believes strict structural separation regulations must be supplemented with effective accounting safeguards as well. Accordingly, CompTel supports the Commission's tentative conclusion to apply its existing affiliate transaction rules to any services provided through separate affiliates, and agrees with the Commission that those rules should be strengthened in the ways proposed in the *NPRM*.[29] Comptel believes such rules should apply to BOC activities required to be separated and also to activities that a BOC or LEC voluntarily conducts through a separate affiliate. As further protection against improper affiliate transactions, CompTel recommends that dominant carrier regulation apply to BOC affiliate services, at least until the FCC can safely conclude that the BOCs have lost their market power in local exchange and exchange access services.

### A. Safeguards for BOC InterLATA Services

In its comments in Docket 96-149, CompTel urged the Commission to establish a clear line separating the operations of the BOC and those of its affiliate providing interLATA services.[30] CompTel submits that the best way to ensure that the BOCs and their separate

[29] *NPRM* at ¶ 64-65.

[30] CompTel Docket 96-149 Comments at 13-17.

affiliates properly allocate costs is to require that they operate in every way as if they were independent entities. Thus, CompTel suggests that the Commission adopt rules to ensure BOC in-region interLATA services are truly separate from the BOC's local exchange services. As explained in more detail in Docket 96-149, these rules should: (1) apply operating safeguards similar to those propose by the Department of Justice for Ameritech's Customers First proposal, (2) prohibit the BOC from joint marketing, sharing administrative functions, and from guaranteeing its affiliate's debts in any way, and (3) requiring the public disclosure of all transactions between the BOC and its affiliate and of the affiliate's operations as if it were a publicly-traded company.[31]

If structural separation rules are adopted that fulfill these minimum criteria, CompTel supports the Commission's tentative decision to apply its affiliate transaction rules to transactions between the BOC and any interLATA affiliates it establishes pursuant to Section 272(a).[32] Accordingly, CompTel agrees that the Commission should treat the interLATA affiliates as nonregulated affiliates under the Commission's joint cost and affiliate transactions rules for exchange carrier accounting purposes.[33] The affiliate should be required to maintain books of account using GAAP, so that the affiliate's books may be audited as necessary to ensure compliance with the Commission's cost accounting rules.

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[31] CompTel Docket 96-149 Comments at 13-20.

[32] *See NPRM* at ¶ 89.

[33] *See Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987) ("*Joint Cost Order*").

In order to reduce the danger of improper affiliate transactions, the Commission should strengthen its existing rules in four ways.

*First*, it should strengthen its rules regarding the valuation of transactions between affiliates. CompTel agrees with the Commission that it should apply a uniform valuation method to all affiliate transactions, whether they be asset transfers or the purchase of services.[34] CompTel also believes that the BOC affiliate should be required to take all services pursuant to the BOCs' generally available tariffs, even if other carriers have signed interconnection agreements with the BOC. The Commission also should prohibit the BOCs from using "prevailing company prices" to value transactions between itself and its affiliate, as this method is rife with uncontrollable discretion.

*Second*, the Commission should strengthen its audit requirements for the services provided by the BOCs' affiliates. Audits are essential to the Commission's ability to determine whether companies are complying with the rules and regulations promulgated under Section 272, including the separate accounting requirements under Section 272(b). As the Commission tentatively concludes in the *NPRM*, audits conducted pursuant to Section 272(b) should include details and the auditor's determination of whether the audited parties are in complete compliance with the affiliate transaction rules and any other non-discrimination requirements, including Sections 272(e)(3) and 272(e)(4).[35] This audit should be separate and in addition to any requirements resulting from the Commission's cost-

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[34] *NPRM* at ¶ 93.

[35] *See NPRM* at ¶ 45 inquiring whether the listed items should be discussed in the independent auditor's report.

accounting rules. Moreover, the cost of the independent audit should be fully paid for by the BOC and included among the BOC's intraLATA costs.

Section 272(d) requires the BOC biennially to submit to an audit "to determine whether such company has complied with this section and the regulations promulgated under this section, and particularly whether such company has complied with the separate accounting requirements under subsection (b) [47 U.S.C. § 272(b)]." To properly implement Section 272(d), it is imperative that the Commission receive sufficient and timely data that will allow it to determine whether the accounting safeguards have worked adequately and to enable improvements to be made where the safeguards appear to be deficient. Because the interLATA restriction sunsets after three years, unless the Commission determines otherwise,[36] it would be a huge mistake for the Commission to wait a full two years following the commencement of service to conduct the first audit. Moreover, a single audit would not provide the Commission with sufficient information regarding the BOCs' and affiliates practices to determine whether it should sunset the interLATA restriction. CompTel submits that it is essential that the Commission receive the benefit of information from two separate audits before it makes a determination of whether to lift the in-region interLATA restrictions.

Thus, CompTel proposes that the Commission require the first audit mandated by Section 272(d) to be conducted six months after the BOC or affiliate commences interLATA operations, with additional audits every two years thereafter. If the first biennial audit is conducted six months after the company commences operations, the affiliate or the BOC will

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[36] *See* 47 U.S.C. § 272(f)(1).

have accumulated enough operation experience in the interLATA market so that an auditor may reach an informed conclusion as to whether the company is operating within the accounting restraints of the Act. Additionally, the auditors will be better positioned to make recommendations as to what changes, if any, are necessary to ensure full compliance with Act and the BOC will be able to implement the auditor's changes while the separate affiliate requirement is in effect. Additionally, by conducting an initial audit after six months, the second audit would take place two years thereafter, approximately six months before the separate affiliate requirement is due to sunset. At this juncture, the Commission will have 2 1/2 years of accounting information to evaluate whether the company has improperly allocated costs or otherwise circumscribed the regulations of the Act. This information would prove most beneficial in determining whether to extend the interLATA restriction or to allow the sunset provision to kick in.

*Third,* as explained in Section IV(A), above, the Commission should prohibit the BOCs from engaging in joint marketing with their affiliates. Joint marketing presents an additional opportunity for the BOCs to cross-subsidize through improper allocation of the joint marketing costs. To reduce this opportunity, the Commission should prohibit BOC-affiliate joint marketing for the duration of the separate affiliate requirement.

*Finally*, as explained in more detail in Docket 96-149, CompTel believes it is inappropriate to extend non-dominant carrier regulation to the BOCs or their in-region interLATA affiliates.[37] It is proper to approach BOC affiliates with caution. The BOC unquestionably possesses market power within its region, and there is a realistic possibility

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[37] *See* CompTel Docket 96-149 Comments at 31-33.

that it may attempt to extend that market power to in-region interLATA services. Therefore, the Commission should initially classify the BOC affiliates as dominant providers and reconsider that classification only after it has had sufficient experience with BOC provision of in-region interLATA services to be confident that the BOC cannot exert market power in this market.

### B. Safeguards for Activities Voluntarily Conducted Through a Separate Affiliate

There are at least three types of services for which a BOC may voluntarily choose to create a separate subsidiary--out-of-region interLATA services, incidental services as defined under Section 271(g) and payphone service. Incidental services includes only those services for which the fact that a transmission crosses a LATA boundary is inconsequential or insignificant. As CompTel stated in its BOC In-Region comments, although there is no separate affiliate requirement, it would be consistent with the Act to implement accounting rules and other non-structural safeguards to limit the BOCs' ability to exercise market power with respect to these services. Accordingly, CompTel encourages the Commission to apply the affiliate transaction rules, with the proposed modifications to incidental services provided by the BOC.

Likewise, CompTel submits that the Commission should apply its affiliate transaction rules to the provision of payphone services. Section 276 implicitly permits any BOC to provide payphone services provided that (1) the BOC does not cross-subsidize its payphone operations with its telephone exchange service or exchange access operations and (2) the

BOC does not "prefer or discriminate in favor of its payphone service."[38] Implementation of the Commission's affiliate transaction rules would help to detect discrimination in violation of Section 276(a)(1) and 276(a)(2). At a minimum, the Commission must prescribe rules that equal the nonstructural safeguards adopted in Computer III.[39]

## CONCLUSION

For the foregoing reasons, CompTel respectfully submits that the Commission should proceed cautiously to implement cost accounting safeguards for BOC and ILEC services. The BOCs and ILEC continue to possess market power that could be used to support anticompetitive cross-subsidies or predatory pricing in various affiliated markets. CompTel believes that accounting safeguards at least as strong as those already in place should be retained, and must be supplemented in certain areas to address greater threats created by

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[38] *See* 47 U.S.C. § 276(a)(1)-(2).

[39] See *Id.* § 276(b)(1)(C).